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PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Appeals
For the Fifth Circuit

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In the Supreme Court of the United States

OCTOBER TERM, 1972

No. ----------.

ERNEST E. POTTER,
Petitioner,

vs.

MOULDINGS, INC.,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Appeals
For the Fifth Circuit

The Petitioner prays that a Writ of Certiorari issue to review the opinion of the United States Court of Appeals for the Fifth Circuit dated August 9, 1972, pursuant to which the judgment of the District Court granting Respondent's Motion for Summary Judgment was affirmed in part and the cause remanded with directions to determine certain facts necessary to the calculation of the amount Respondent is entitled to recover. A petition for rehearing was denied on September 15, 1972.

OPINIONS DELIVERED IN THE COURTS BELOW

The opinion of the United States District Court for the Middle District of Georgia granting the Respondent's Motion for Summary Judgment and denying Petitioner's Motion for Summary Judgment has not been reported, and a copy of this opinion is appended hereto at pp. 19-27 of the Appendix. The judgment of the United States District Court for the Middle District of Georgia and the amendment thereto have not been reported, and a copy of the judgment and the amendment thereto are appended hereto at pp. 28-29 and 30-31, respectively, of the Appendix. The opinion and judgment of the Court of Appeals for the Fifth Circuit affirming the District Court in part and remanding the cause with instructions to determine certain facts has not yet been reported, and a copy of the opinion and judgment are appended hereto at pp. 32-39 and p. 40, respectively, of the Appendix. A copy of the Court of Appeals' denial of the Petition for Rehearing is appended hereto at p. 41 of the Appendix.

JURISDICTION

The opinion of the Court of Appeals is dated August 9, 1972, and its per curiam denial of the Petitioner's Petition for Rehearing is dated September 15, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

THE QUESTIONS PRESENTED FOR REVIEW

(1) Whether the Court of Appeals erred in holding that an insider who inadvertently places an order with his broker for a "short sale" will not be permitted to structure his subsequent transactions in a manner which avoids liability under Section 16(b) of the Securities Exchange Act of 1934 [15 U.S.C. §78p(b)].

(2) Whether the Court of Appeals erred in holding that Petitioner's transactions were "garden variety" sales and purchases for which there was no need to employ "possibility of abuse" analysis in order to determine the applicability of Section 16(b) of the Securities Exchange Act of 1934 [15 U.S.C. §78p(b)] to the transactions.

(3) Whether the Court of Appeals erred in holding that a novation of an attempted sale of securities by an insider is in substance a "purchase" of stock by him.

(4) Whether the Court of Appeals erred in holding that Petitioner realized profits by arranging a novation of his attempted sale of securities.

THE STATUTES INVOLVED

The statutes involved are Sections 3(a) (13), 3(a) (14) and 16(b) of the Securities Exchange Act of 1934 [15 U.S.C. § §78(c) (a) (13) and (14) and 78p(b)]. These statutes are appended hereto at p. 42 of the Appendix.

STATEMENT OF THE CASE

Petitioner Ernest E. Potter (hereinafter "Potter"), an officer and director of Mouldings, Inc. (hereinafter "Mouldings"), first acquired Mouldings stock in 1968 as part of an exchange agreement with Mouldings. The stock was unregistered and its sale was restricted in order to qualify the exchange for the private offering exemption from registration. [See §4(2) of the Securities Act of 1933, 15 U.S.C. §77d(b)]. The stock certificates for these shares bore legends indicating the existence of the restriction on sale. Mouldings later registered a new offering of its shares and became listed on the American Stock Exchange. Potter thereafter bought registered Mouldings stock for which he received unlegended certificate. Mouldings subsequently declared two 100% stock dividends. The certificates for the dividend shares on the restricted stock should have been legended to indicate that they also were restricted. However, Mouldings' transfer agent sent Potter unlegended certificates for the bulk of the dividend shares on the restricted stock, as well as for the dividend shares on his registered stock.

Potter, relying on what the legend indicated about nature of his stock, placed an order with Bache and Company (hereinafter "Bache") as his broker, to sell the balance of his Mouldings stock. On November 3, 1969, he sent Bache unlegended certificates representing 11,000 shares. He also directed Bache to buy various stocks for his account, intending to apply the proceeds from the sale of his Mouldings stock to their purchase price.

Bache began placing Potter's Mouldings shares for sale on his account in early November, 1969, and had placed 8,000 of the shares before Potter learned of the transfer agent's mistake and notified Bache on November 19, 1969, to stop placing his "sell" order. Bache continued, however, to purchase other stocks in accordance with Potter's purchase order.

After consultation with his attorneys and with attorneys for Bache and Mouldings, Potter decided that, to extricate himself from the predicament of having unwittingly attempted to sell restricted stock, he would arrange to cancel his attempted sales and to transfer the sales to other persons whom he knew to be Mouldings stockholders and who would furnish unrestricted shares and receive in return the proceeds of the sales. Eleven persons ultimately supplied unrestricted stock to Bache and received from Bache the proceeds of the sales. Potter in the meantime asked Bache how much he owed it to cover the purchases of stock in other companies it had made for his account; and on January 30, 1970, Bache received his certified check for that sum. At various times in February Bache sent checks to the substituted sellers of Mouldings stock in payment of their proceeds from sales. The price of Mouldings stock had declined steadily from its November, 1969, level throughout this period.

Mouldings brought an action in the District Court premised on §16(b) for the recovery of the profits allegedly realized by Potter from his November, 1969, "sales" of Mouldings stock and matching "purchases" from the substituted sellers. After some discovery in the case, both Mouldings and Potter moved for summary judgment. The District Court granted Mouldings' motion and determined the amount of Potter's alleged profits by choosing February 9, 1970, the date on which Bache made journal entries with respect to the sale of 6,900 of shares to indicate the transfer of the attempted sales to the accounts of the substituted sellers, as the date of the matching "purchases." The Court of Appeals affirmed the judgment for Mouldings, but remanded the case for further findings with respect to the date upon which the "purchases" occurred.

REASONS FOR GRANTING THE WRIT

I. In holding, in effect, that an insider's efforts to extricate himself from an inadvertent "short sale" in substance will inevitably involve a "sale" and "purchase," the Court of Appeals for the Fifth Circuit ignored this Court's ruling in Reliance Elec. Co. v. Emerson Elec. Co. that a lawful form chosen to avoid liability under Section 16(b) is entitled to recognition.

The Court of Appeals did not take issue with Potter's argument that there had been a novation of his attempted sales of Mouldings whereby the substituted sellers became obligated to complete Potter's contract for the sale of stock by delivering freely transferable shares and entitled to receive in turn the proceeds of the sale. It did not discuss the decisions of lower courts which have recognized that an insider may escape a prior transaction via contractual techniques such as rescission without incurring §16(b) liability. *E.g., Kahansky v. Emerson Radio & Phonograph Corp.*, 184 F. Supp. 90 (S.D.N.Y. 1960); *Hennessey v. Fein*, 184 F. Supp. 86 (S.D.N.Y. 1960); *cf. Landy v. United Fruit Co.*, 305 F. Supp. 254, 257 (D.N.J. 1969); *Weisman v. Spector*, 158 F. Supp. 788 (S.D.N.Y. 1958). Rather, it asserted that it could not permit the novation to remove Potter's transactions from the scope of §16(b), because to do so would exalt form over substance.

It is undenied that Potter structured his transactions in a form intended to avoid §16(b). The Court of Appeals, without benefit of facts or law to support its conclusion, in effect held that a "short sale" inevitably involves both a clear cut "sale" and a clear cut "purchase" and concluded that it must disregard the novation, look to the "substance" of the transactions, and regard them as "garden variety" sales and purchases.

The Court of Appeals apparently relied on a summary of the typical short sale which appears in one of the

reporting services (App. at 34 n. 2). The summary erroneously implies that the obligations of the seller are identical to his broker's obligations to the buyer's broker. The opinion fails even to discuss the fact that the customary law of contracts is not suspended because securities are involved, a point illustrated by the rescission cases cited *supra*, p. 6. Those cases demonstrate that original parties to a contract for the sale or purchase of securities can extricate themselves from their agreement without automatically invoking §16(b).

The District Court did attempt to rely on the rules of the American Stock Exchange, which are designed speedily to "close" transactions over the Exchange, to support its conclusion that there is no way to "transfer" a sale of securities (App. at 25). However, the rules of the Exchange govern the relationship of member brokers to one another, not the obligations of a customer to his broker or to another customer.[1] Neither Mouldings nor the courts below have pointed to any rule of the Exchange or principle of law which precludes a novation of a contract to sell securities.

Because the Court of Appeals defined Potter's transactions as "garden variety" sales and purchases which automatically trigger §16(b) if they occur within the statutory six months period, the court found it unnecessary to determine whether there were any possibilities of speculative abuse inherent in Potter's transactions.[2]

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[1] To the extent that the District Court, and, in turn, the Court of Appeals, rested their conclusions on a view of the mechanics of trading on a stock exchange, they did so without benefit of a fully developed record explaining Bache's customary procedure, how Bache satisfied the buyers' brokers in the November transactions vis-a-vis their expectation that they would soon receive certificates representing the shares they had purchased, etc.

[2] The "possibility of abuse" test is generally recognized as a method whereby the court determines if transactions which have none of the common indicia of "purchases" and "sales," as those

(Footnote continued on following page)

It is submitted that the Court of Appeals erred in failing initially to give credence to the form of Potter's transactions and then proceeding to apply the possibility of abuse test to determine if §16(b) must apply to that form under the expansive definitions of "sale" and "purchase" used whenever they effectuate the purposes of the statute. The Court of Appeals' approach was similar to that of the trial court in *Emerson Elec. Co. v. Reliance Elec. Co.*, 306 F. Supp. 588 (E.D. Mo. 1969), *rev'd*, 434 F.2d 918 (8th Cir. 1970), *aff'd*, 40 U.S.L.W. 4125, 92 S. Ct. 596 (Jan. 11, 1972). In that case a company which had acquired more than 10% of the issuer's outstanding shares [thus becoming an "insider" under §16(b)] in an unsuccessful effort to take over the issuer, disposed of its entire holdings in two sales within six months of the purchase. The first sale reduced the insider's holdings to 9.96% and the second disposed of the balance of the shares. The district court inquired into the motive behind the split sale—avoidance of §16(b) liability—and "looking through form to discern substance" held that the two sales were part of a single plan. Thus it concluded that the shareholder was a holder of more than 10% of the stock "at the time of sale," as that phrase is used in

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(Footnote 2 continued)

terms are used in the law of sales and contracts, involve the possibility for speculative abuse which §16(b) is to deter. If such a possibility of abuse is present, the transactions will be deemed "purchases" and "sales." *Petteys v. Butler*, 367 F.2d 528, 536 (8th Cir. 1966), *cert. denied sub nom. Blau v. Petteys*, 385 U.S. 1006 (1967). *See also Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied* 400 U.S. 354 (1972); *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970); *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); *Ferrailo v. Newman*, 259 F.2d 342 (6th Cir.), *cert. denied*, 359 U.S. 927 (1958); *but see Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3rd Cir. 1965). A textual footnote in *Reliance Electric* indicates that this Court regards the possibility of abuse test as consistent with its holding, if it is applied when the statute itself is susceptible of an alternative construction. *Emerson Electric Co. v. Reliance Electric Co.*, 40 U.S.L.W. 4125, 4127 n.4; 92 S. Ct. 596, 600 n.4 (Jan. 11, 1972).

§16(b), for both transactions since they were parts of a single plan of disposition. 306 F. Supp. at 592. In the instant case the Court of Appeals believed that a short sale invariably involves a purchase in order to complete delivery and thus disregarded "form" for the "substance" of Potter's transaction—extrication from a short sale. In affirming the Eighth Circuit's reversal of the district court in *Reliance Electric*, this Court held that:

> "Liability cannot be imposed simply because the investor structured his transaction with the intent of avoiding liability under §16(b). The question is rather whether the method used to 'avoid' liability is one permitted by the statute."

Reliance Elec. Co. v. Emerson Elec. Co., 40 U.S.L.W. 4125, 4126, 92 S. Ct. 596, 599 (Jan. 11, 1972). Although Potter's brief to the Court of Appeals for the Fifth Circuit cited the Eighth Circuit's opinion in *Reliance Electric* and Potter by letter advised that court of this Court's holding prior to the oral argument, the Court of Appeals' opinion in the case at bar totally ignored *Reliance Electric* and clung to an outmoded view of the role of "substance" and "form" distinctions under §16(b). Potter submits that certiorari should be granted to review that holding.

II. Because Potter's transactions posed no possibilities for speculative abuse, the Court of Appeals erred in affirming the District Court's denial of his motion for summary judgment.

A. *Potter's transactions with the substituted sellers were not clear cut "purchases."*

The Court of Appeals premised its opinion on the improper syllogism: "Short sales" are usually completed by a purchase. This is a short sale; *ergo*, there was a matching purchase (and anything which appears to the

contrary is mere form). As demonstrated *supra*, pp. 6-9, there is no basis for the Court of Appeals' refusal to analyze Potter's transactions in the form in which they occurred to determine if they created a possibility for speculative use.

Potter in the instant case was in the same position as a seller in a contract for the sale of goods who assigns both the duty of delivering the goods, *i.e.*, unrestricted securities, and the right to the purchase price to others (here the substituted sellers). Bache was in consultation with Potter at all times about these transactions and clearly assented to the assignment whose purpose was to substitute others for Potter in the position of sellers; such an "assignment" amounts to a novation.[3]

The most common usage of "purchase" is to indicate the payment of a price in money or its equivalent to obtain something as one's own. *Ferraiolo v. Newman*, 259 F.2d 342, n. 2 at 344 (6th Cir. 1958); *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir. 1949) *cert denied*, 337 U.S. 907; *Bowles v. Nelson-Ricks Creamery Co.*, 66 F. Supp. 885, 888 (D. Idaho 1946); *Hodge Shipbuilding Co. v. City of Moss Point*, 144 Miss. 657, 110 So. 227, 228 (1926). It is readily apparent that a novation does not fit neatly into the term "purchase" in its customary sense.

---

[3] As Corbin has observed:

"In the case of a bilateral contract to sell goods ordinarily obtainable in the market, the seller can assign his right to the price and can delegate performance of the duty to deliver the goods. The assignee can maintain suit for damages, just as assignor could, if the buyer repudiates before tender or refuses to accept or pay for goods tendered according to contract." A. Corbin, 4 *Corbin on Contracts* §865, p. 448 (1951).

Moreover:

"If it clearly appears from the terms of the assignment transaction that the assignee intends to undertake the duty to perform for the assignor, and that the latter intends to be himself no longer bound, there is a discharge of the assignor by novation if the third party accepts performance by the assignee with knowledge of the terms of the assignment or otherwise assents to those terms." *Id.*, §866, p. 457.

B. *The Court of Appeals should have applied the possibility of abuse test and concluded that Potter is entitled to summary judgment.*

The proper course of action for a court confronted with a transaction which is not a clear cut purchase or sale is, as indicated *supra*, p. 7, n. 2, to analyze it to see if it poses any of the possibilities for speculative abuse which §16(b) is designed to prevent. Although the statute itself makes the insider's intent to gain a speculative advantage irrelevant if the transactions are otherwise clearly within the statute, it does not require a court to ignore all facts surrounding a series of transactions which in themselves are not clearly purchases and sales. The question of Potter's good faith in believing that his stock was unrestricted can and should be considered in determining whether, on the facts of the particular case at bar, the situation was ripe for the speculative abuse which §16(b) seeks to prevent.

An insider who in good faith delivers stock believing it to be unrestricted to consummate a sale of securities that does not in itself violate §16(b) is not entering a course of conduct calculated to foster his speculative advantage. When placed in such a predicament, the insider has no real option—he must somehow quickly fulfill his contractual duties, be relieved of them, or stand ready to pay damages. If the insider lacks sufficient unrestricted shares to fulfill the contract, he is in no position to condition his moves in accordance with his inside information. Regardless of which way the price of his corporation's stock may fluctuate, the insider is "out" the equivalent of the purchase price. If the insider purchases stock, then he will violate §16(b), for if there is clearly a purchase and sale, the statute offers the court no room for extending its sympathies to the insider and any profits will inure to the issuer.

If, however, the insider seeks to avoid violating the prohibition against short swing profits by paying damages or by making an arrangement which releases him from any liability on the sales contract, then there is no reason to force the label "purchase" on the steps he undertakes, for the insider in either event loses the benefit of the price he would have been entitled to receive under the sales contract.

The instant case illustrates this phenomenon quite well, for Potter in pursuading Bache to a novation of his contract rights and duties lost his right to the sales price for the stock. To make matters worse, he had to pay a considerable sum to cover stock purchases he made in anticipation of the consummation of his Mouldings sales—purchases that in all probability he would not have made had he not believed that his sale of Mouldings stock could be completed with the certificates he had delivered to Bache.

The leading commentator on questions of securities law has observed that:

> "Although actual motive is irrelevant, the absence of *any possibility of improper motive* is sometimes relevant, it seems, in determining whether a [transaction] involves a 'purchase' or 'sale'." 2 L. Loss, *Securities Regulations,* p. 1041, n. 14 (1961) (emphasis in original).

Professor Loss further states that it is "of considerable consequence to consider whether the circumstances were such that defendant could possibly have obtained an advantage over the public generally which did not already exist." *Id.* at 1069-70.

Potter repeatedly indicated in his deposition that he had no knowledge that there had been an error in legending his May, 1969, dividend shares and that 7,686 of them were restricted stock. For example:

"Q. What I'm saying is wasn't more than half of the stock that you received as a dividend, wasn't that restricted stock the same as the original stock you got in the merger?

A. No, I never understood it to be restricted stock." (Dep. of Potter, p. 5).

* * * * *

Q. Is there any doubt in your mind that you didn't [receive a letter informing you of the error in legending and that the stock was restricted] in May of 1969?

A. There is no doubt in my mind that I didn't receive that; I wasn't knowledgeable of it, I'll put it like that.

Q. And the next time you heard about it was in November, is that correct?

A. That's the first time I heard of it." (Dep. of Potter, p. 10)

In the instant case, Potter, the insider who in good faith delivered securities to a broker for sale and subsequently learned that he could not fulfill his obligation to deliver unrestricted shares, could not have obtained an advantage over the public generally and thereby converted his predicament into an opportunity for speculation.

If Mouldings contends that the possibility for abuse is that the insider will use the situation to benefit his friends and associates, the possibility of such a "scheme" gives the insider no greater advantage than he always has, for the insider can at any time tell friends to buy or sell on the basis of his inside knowledge of the corporation's prospects—yet §16(b) does not cover such a situation.[4]

[4] Early drafts of §16(b) would have made the profits of anyone to whom inside information was disclosed subject to its provision. However, this broadening of §16(b) was explicitly rejected by Congress when it passed the statute. *See Blau v. Lehman*, 368 U.S. 403, 411-413 (1962), for a discussion of this legislative history. Such "tipping" would, however, raise questions under §10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (1964) and 17 C.F.R. §240.10b-5 (1942).

If it be proved that the insider has no knowledge that he has delivered restricted stock for a sale that would not itself violate §16(b), then any possibility that the insider was placing himself in a position to speculate at his corporation's expense disappears.

In view of the foregoing, Potter submits that the Court of Appeals erred in affirming the District Court's denial of his motion for summary judgment. The absence of any opportunity for speculative abuse by Potter makes inappropriate any expansion of those terms to include Potter's transactions with Bache and the substituted sellers. Therefore, as a matter of law, judgment should be entered for Potter.

III. Even if, as a matter of law, Potter "sold" and "purchased" Mouldings stock within six months, the Court of Appeals erred in relying upon the Second Circuit's definition in Blau v. Lehman of "profits realized," rather than the Third Circuit's definition in Heli-Coil Corp. v. Webster and therefore holding that Potter had realized profits from the transactions.

If Potter did "purchase" the substituted sellers stock, he did so by paying the same price that he had received when he allegedly sold Mouldings in November. Mouldings contends, however, that Potter could have purchased 8,000 shares in the open market at that same time for a lower price and that the difference between the market price Potter could have paid on the date he made the purchases and the price at which he sold Mouldings stock was "profit."

Section 16(b) requires the insider to return to the issuer "any profit realized by him from . . . any sale and purchase." The terms "profit" and "realize" are not defined in the Securities Exchange Act of 1934 [15 U.S.C.

§78 *et seq.*], but Mouldings maintains that, even though Potter never "pocketed" the alleged difference, he nevertheless realized a profit.

The Court of Appeals relied upon the broad definition of "profit realized" which is found in *Blau v. Lehman*, 286 F.2d 786, 790-791 (2d Cir. 1960). There a defendant was both a director of the issuer and a partner in a brokerage firm. As a partner he was a beneficial owner of any stock owned by the partnership and was entitled to a share of any profits realized by the brokerage firm on its transaction in securities. Thus, whenever the brokerage firm realized a profit on a short swing transaction in the issuer's stock, the defendant director was entitled to a share of the profits and therefore had "realized" profits within the meaning of §16(b). The subsequent waiver of his rights to participate in the profits could not undo the fact that he already had realized profits and therefore become liable to the issuer for those profits under §16(b).

Blau v. Lehman articulated a strained concept of "profit realized" to reach the unique problems posed by brokerage partnerships, and the Court of Appeals erred in extending its principles beyond the narrow factual basis upon which they rest. The opinion of the district court in *Blau v. Lehman* pointed out the policy consideration which justified such an extended view of what constitutes "profits realized":

> "To permit a partner to waive the cash receipt of his partnership share and thus escape liability is to create a situation which would frustrate the remedial purpose of §16(b). It would permit the avoidance of the statute by insider-partners of the same partnerships but of different directorships by allowing them to interchange information and then waive the receipt of their share. This would result in each partner at various times benefiting from this mutual waiver." 173 E. Supp. 590, 595 (S.D.N.Y. 1959).

This rationale is repeated in the opinions in the Second Circuit decision. *See, e.g.*, 286 F.2d at 786, 791 (opinion of Judges Medina and Swan). The unique condition of continuing mutual access to inside information of different corporations which so strongly shapes the thinking of the courts in *Blau v. Lehman* simply is not present in the case of Potter and the substituted sellers from whom he allegedly purchased Mouldings stock.

The Court of Appeals also made reference to the fact that §16(b) casts the officer-director thereunder into a fiduciary capacity for the benefit for all the shareholders in the corporation (App. at 38). That observation would be appropriate in any case involving §16(b). However, it has not affected the approach adopted by other courts in interpreting "profits realized."

Regarding the meaning of "realize," the Third Circuit has observed that:

> "Since Congress did not define the term 'realize' we may assume that it intended the word to have its ordinary meaning and that it was not employed as a term of art. '[R]ealization' means 'to realize,' says Webster's International Dictionary (2d ed. 1948) giving as the term's first meaning: 'to convert an intangible right or property into real (tangible) property; hence, to convert any kind of property into money.'
>
> The term 'profit,' being undefined by the Act, must also be assumed to have its ordinary or usual meaning. The word 'profit' is defined by the same authority as meaning 'gain' as well as 'the excess of the price paid for goods sold.' Bouvier's Law Dictionary (Rawle's Third Revision 1914) describes 'profit' as 'the advance in the price of goods sold beyond the costs purchased'." *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 167 (3d Cir. 1965). [Footnotes omitted]

The same court also cited[5] with approval the definition used in *U. S. Smelting, Refining & Mining Co. v. Haynes,* 111 Utah 172, 176 P. 2d 622, 623 (1947):

> "Money, property or profits 'realized' usually means brought into possession, and the word does not include paper profits or estimated profits, but is usually used in contrast to hope or anticipation but it need not be cash in hand to be realized gain or income."

If an insider has not brought a "profit" into possession as cash in hand, then the courts have analyzed the transactions to see if the insider received any economic benefits from them. Only if the insider has derived a benefit is any purpose of §16(b) served by requiring him to pay over to the corporation the "profit." Cf. *Newmark v. RKO General, Inc.,* 425 F.2d 348, 355 (2d Cir 1970) (court focuses on insider's attempt to turn short swing transactions to his own personal advantage, rather than on his receipt of cash in hand); *Alloys Unlimited, Inc. v. Gilbert,* 319 F. Supp. 617 (S.D.N.Y. 1970) (since the insider derived an economic benefit from the sale by a bank of stock pledged to the bank as collateral for loan, he realized a profit to the extent that the price at which the bank sold the stock exceeded the purchase price paid by the insider).

Since Potter never brought any profits into his possession as cash or property, the District Court erred in holding that it was unnecessary to determine whether Potter received any direct or indirect benefit in the form of money, services or favors from those persons to whom he allegedly paid $200,385.54 for their stock. The Court of Appeals, relying upon *Blau v. Lehman,* held that "profit realized" is sufficiently broad to cover the transaction at bar and thus declined to consider Potter's argument that the record revealed no economic benefit to him from the transactions, despite the attempts by counsel for

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[5] *Heli-Coil Corp. v. Webster, supra,* 352 F.2d n. 14 at 167.

Mouldings in the depositions of Potter and four of the substituted sellers to draw forth an admission that Potter was to receive "something," or expected to receive "something," from the transactions. Since *Blau v. Lehman* should be limited to its special facts, the Court of Appeals should have applied the definition of *Heli-Coil Corp. v. Webster* and proceeded to determine whether any direct or indirect benefits flowed to Potter. Since the undisputed facts before the courts below revealed no form of benefit to Potter, Potter was entitled to summary judgment, even if the courts below correctly held that there had been sales and purchases within the ambit of §16(b).

CONCLUSION

For the reasons aforesaid, it is respectfully prayed that a writ of certiorari be granted to review the judgment of the United States Court of Appeals for the Fifth Circuit.

Respectfully submitted,

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APPENDIX

DECISION OF THE DISTRICT COURT

(June 8, 1971)

CIVIL ACTION NO. 712
IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF GEORGIA
AMERICUS DIVISION

MOULDINGS, INC.,
Plaintiff,

v.

ERNEST E. POTTER, WALLACE SUMMERS, FLOYD MARTIN AND BLUE LINE CORPORATION,
Defendants.

OPINION AND ORDER ON MOTIONS FOR SUMMARY JUDGMENT

This action was filed in two counts. In Count One Plaintiff sought to enjoin the Defendants from violating non-competition covenants contained in employment agreements. That feature of the case has already been dealt with by this Court. See *Mouldings, Inc. v. Ernest E. Potter, Wallace Summers, Floyd Martin, and Blue Line Corporation, 315 F. Supp. 704 (1970).*

Count Two, with which we now deal, is a suit in equity and jurisdiction arises under the Securities Exchange Act of 1934, 15 U.S.C.A. §78a, et seq., and only one of the Defendants above named is concerned in this count, the controversy here being between Mouldings, Inc. ("Mouldings") and Ernest E. Potter ("Potter"). Extensive discovery has been completed by the parties and Mouldings and Potter have each filed motions for sum-

mary judgment. A review of the pleadings, the affidavits and matter developed by the discovery process indicates that there is no longer any controversy regarding any fact material to a determination of this matter and that it is appropriate that either the Plaintiff's motion or the Defendants' motion should be sustained.

The common stock of Mouldings was registered with the Securities and Exchange Commission on May 11, 1969 pursuant to Section 12 of the Securities Exchange Act of 1934. This Act (15 U.S.C.A. §78p) provides:

> "(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78L of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78L(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.
>
> "(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such

issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

For some time prior to November, 1969 and during November, 1969 and thereafter until he resigned in February, 1970, Potter was both an officer and director of Mouldings.

In November, 1969 Potter was the owner of several thousand shares of Mouldings stock, which shares had been acquired in a private offering and were restricted in that they could not be sold unless they were first registered with the Securities and Exchange Commission. In that month Potter mailed certificates representing ownership by him of 11,000 shares of Mouldings stock to the Chicago office of Bache & Co., Incorporated, a brokerage firm, with instructions to sell these shares. Bache promptly sold 8,000 shares on the American Stock Exchange at an aver-

age price of approximately $25.00 per share and credited Potter's account with the net proceeds, which totaled $200,385.54. These proceeds were then reinvested by Bache at Potter's request in other securities. At the time these sales were executed Bache was unaware of the fact that Potter's shares had been acquired in a private offering and had not been registered under the Securities Act of 1933. After the sales had been consummated and the proceeds received and reinvested, but before Bache had delivered Potter's stock certificates to the brokers who handled the transactions for the purchasers, Bache learned that Potter's shares were restricted against transfer and Bache, therefore, found itself in the position of not being able to make delivery of these certificates. Since the sales had been made, Bache as broker and Potter as seller were under a legal duty to acquire 8,000 unrestricted shares of Mouldings stock which could be delivered to the purchasers. Potter could have acquired the 8,000 shares needed by buying them on either the American or the Pacific Coast Stock Exchanges at the then prevailing market price and if Potter had not himself purchased the shares to cover the shortage Bache under normal circumstances would have acquired the 8,000 shares of Mouldings stock for Potter's account by buying them on the Exchanges and charging the cost of the purchase to Potter, using the shares to conclude the sales which Potter had made.

In the interim, however, since the date of the sales, the price of Mouldings stock had steadily declined on the Exchanges (of which fact Potter was, of course, aware) and since Potter was an officer and director of Mouldings, the profit which would necessarily be realized when the purchases were made would have had to have been paid by Potter to Mouldings, as required by §16(b) of the Securities Exchange Act of 1934.

In an attempt to avoid the consequences of §16(b) Potter instructed Bache not to "cover" the sales by buying Mouldings stock on the Exchange, but instead to "buy" the 8,000 shares needed for Potter's account at an artificially inflated price from certain friends and business associates of Potter whose names Potter furnished to Bache. Potter instructed Bache not to pay these named persons the then prevailing market price, but to pay them approximately $25.00 per share, which was the price Potter had received when he sold his stock in November. Potter then furnished Bache the $200,385.54 to remit to his friends. On February 2, 1970, the date Bache received the funds from Potter to purchase the Mouldings stock, the stock closed at the American Stock Exchange at 11⅞ and on February 9, 1970, the date the purchases were consummated, the stock closed at 12⅛. Therefore, had the 8,000 shares been acquired by Bache on the open market on February 9, 1970, Bache would have paid $97,000.00 for the stock rather than the $200,385.54 which it did pay to Potter's friends. Potter's obvious purpose in making this arrangement was to divert the profit which would have gone to Mouldings and its shareholders under the provisions of §16(b) to a select group of shareholders composed of friends and business associates of Potter. The profit involved is the difference of $103,385.54 between what Potter received in November and what Bache or Potter could have acquired the stock for on the open market in February. It is these profits, the disposition of which Potter controlled and directed, which Mouldings seeks to recover.

It has been stated that the purpose of §16(b) is to deter corporate insiders from taking advantage of inside information in trading their company's securities.

> "The undoubted congressional intent in the enactment of §16(b) was to discourage what was rea-

sonably thought to be a widespread abuse of a fiduciary relationship—specifically to discourage if not prevent three classes of persons from making private and gainful use of information acquired by them by virtue of their official relationship to a corporation. The objective was not to punish but to deter the persons in these three categories—directors, officers, 10% beneficial owners—from making improper use of information gained in a representative capacity. The practices could not be prevented in toto but Congress sought to take the profit out of what it considered improper conduct. It is plainly a remedial step, as opinions of this court have indicated, even though in certain circumstances the remedy seems harsh. The statute channels the insider profits back into the corporation, not to an informant or person directly suffering a loss.

"Unlike a criminal statute where intent would be an essential ingredient this statute renders the subject accountable for proscribed profits regardless of intent."

Adler v. Klawans, 257 F.2d 840, at 844 (2 Cir., 1959).

It is also clear that for liability to be established it is not necessary that the evidence show that the insider actually took advantage of inside information. The statute envisions an objective measure of proof providing that if the insider makes sales and purchases or purchases and sales within a six months period and any profit is realized the corporation is entitled to recover the profits regardless. This mechanical objective test is apparently the result of a recognition by the Congress that in many instances it would be difficult if not impossible to prove that the insider actually took advantage of inside information. See *Smolowe v. Delendo Corporation*, 136 F.2d 231 (2 Cir., 1943); cert denied 320 U.S. 751 (1943).

Here the record clearly supports the contention of

Mouldings that Potter sold and purchased 8,000 shares of Mouldings stock within a six month period and as a result of a declining market substantial profits were realized, and it avails nothing to observe that although Potter was an officer and director of Mouldings at the time of the sale he had resigned his positions effective February 1, 1970 just prior to the purchase of 8,000 shares from his friends and associates. This is true because §16(b) requires that a person be an officer or director at the time of his purchase *or* at the time of his sale, but not both times.

The suggestion that the November sales of Mouldings stock were made by Potter's friends and not by Potter himself is hardly worthy of serious consideration. The record shows that Potter's friends did not even have accounts with Bache in November and there is no provision in the law or under the rules of the American Stock Exchange for "transferring" sales which have already been made. Bache's records clearly show that the sales were made by Potter in November and that Bache acquired for Potter's account 8,000 shares of Mouldings stock in February.

Potter contends that even if there were sales and purchases within a six months period he did not "receive" any of the profits. The test, of course, is not whether he "received" any profit, but is rather whether he "realized" any profit, and when he directed and controlled the disposition of $103,385.54 which otherwise would have gone to Mouldings he "realized" profits within the meaning of §16(b). He disposed of the profits and to that extent he realized profits. See *Blau v. Lehman*, 173 F. Supp. 590 (S.D.N.Y., 1959), affm'd. 286 F.2d 785 (2 Cir., 1950), and 368 U.S. 403 (1962). Although such might be easily imagined, it is not necessary for the evidence to show that the insider who controlled the disposition of the profits did

receive or was to receive any direct or indirect benefits in the form of money, services or favors from his friends and associates who were the objects of his generosity. The fact would still remain that the insider had controlled and directed the disposition of a substantial sum of money in contravention of §16(b) and the other shareholders of the corporation would have been damaged just as much as they would have been had the insider retained the profits. Simply stated, §16(b) (and not the insider) determines where such profits shall go.

In the brief filed on behalf of the Defendant it is suggested that the evidence does not clearly show that Potter was in fact aware that his shares were restricted at the time he delivered his certificates to Bache in November, 1969. Were it necessary for this Court sitting as a court of equity to decide that question we would have no difficulty in deciding that he did have such knowledge because such a conclusion is indicated by many circumstances. What we do decide is that whether or not Potter had such knowledge is not material insofar as the basic question of §16(b) liability is concerned, for even if he did not have such knowledge he would still be liable to Mouldings for the profit which he realized. This is so because §16(b) operates irrespective of the intentions of the insider, it being specified in the statute that the profit inures to the benefit of the issuer "irrespective of any intention on the part of such beneficial owner, director, or officer in entering into any such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months." The *only* consideration is whether or not Potter realized profits from the sale and purchase of Mouldings stock within a six month period. If he did Mouldings is entitled to recover, and Potter's knowledge, information, thought processes or reasons for making the initial sales or subsequent purchases are immaterial. It

may be noted in passing that even if Potter had not learned that the shares were restricted until after Bache had made the sales in November, 1969, he still could have solved his problem quite simply by buying the necessary shares on the Exchange at the prevailing price and then paying the profit to Mouldings, as is required by §16(b).

Finally, we deal with the contention made by Potter that it would be inequitable to allow the Plaintiff corporation to recover the profits on his transactions because, as he suggests, "Section 16(b) is not designed to benefit the Plaintiff, but to penalize the insider who profits." A reading of the statute makes it clear that §16(b) was designed to be both penal and remedial. As was said by the District Court for the Southern District of New York in *Epstein v. Shindler*, 200 F. Supp. 836 (1961);

> "There is, unquestionably, a public interest sought to be protected by the Securities Exchange Act. But it is not the public at large which is specifically protected by section 16(b) so much as the 'outsiders,' that is, the general body of stockholders not having the advantage of inside information. *The statute redresses a wrong to them by the return of profits to the corporation itself.*"
> (Emphasis supplied.)

Consistent with the foregoing, the Plaintiff's motion for summary judgment is sustained and it is directed that as to Count Two of the complaint judgment be entered for the Plaintiff against the Defendant Potter as prayed for.

This 8th day of June, 1971.

J. ROBERT ELLIOTT
United States District Judge

JUDGMENT OF THE DISTRICT COURT
(June 25, 1971)

CIVIL ACTION No. 712

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF GEORGIA
AMERICUS DIVISION

MOULDINGS, INC.,
Plaintiff,

v.

ERNEST E. POTTER, et al,
Defendants.

JUDGMENT

The motions for summary judgment with respect to Count Two of the plaintiff's complaint heretofore filed by the plaintiff, Mouldings, Inc., and the defendant, Ernest E. Potter, having come on for determination by the Court, and the Court having given consideration to the pleadings and the evidentiary matter which has been developed, and to the briefs filed herein, and the Court having rendered on June 9, 1971 an opinion and order granting the plaintiff's motion for summary judgment, and denying the defendant's.

IT IS THEREFORE ORDERED, ADJUDGED AND DECREED THAT:

1. The plaintiff's motion for summary judgment on Count Two be and the same is hereby granted.

2. The plaintiff, Mouldings, Inc., recover of the defendant, Ernest E. Potter, the sum of $103,385.54, as principal, and $9,910.60 as interest on said sum from

February 9, 1970 to date, together with future interest from date at the rate of 7% as provided by law, and its costs of action.

3. The defendant's motion for summary judgment on Count Two be and the same is hereby denied.

Dated at Columbus, Georgia, this 25 day of June, 1971.

/s/ J. ROBERT ELLIOTT
United States District Judge

AMENDMENT TO THE JUDGMENT OF THE DISTRICT COURT

August 17, 1971

CIVIL ACTION No. 712

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF GEORGIA
AMERICUS DIVISION

MOULDINGS, INC.,
Plaintiff,

v.

ERNEST E. POTTER, WALLACE SUMMERS, FLOYD MARTIN AND BLUE LINE CORPORATION,
Defendants.

AMENDMENT TO ORDER

The motion of defendant Ernest E. Potter to amend this Court's order of June 25, 1971, denying said defendant's motion for summary judgment, by adding thereto the statement required by 28 U.S.C. §1292 (b) as a prerequisite to an appeal from an interlocutory order and brief in support thereof having been read and considered, and it appearing to the Court that grounds for an immediate appeal are present in this matter in view of said defendant's appeal from the granting of plantiff's motion for summary judgment contained in the same order,

IT IS HEREBY ORDERED that said order is amended by adding thereto the following paragraph:

> "4. This Court is of the opinion that the denial of defendant's motion for summary judgment involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from that portion of this order may

materially advance the ultimate termination of the litigation."

This 17 day of August, 1971.

/s/ J. ROBERT ELLIOTT
United States District Judge

OPINION OF THE COURT OF APPEALS
(August 9, 1972)

No. 71-2867

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

MOULDINGS, INC.,
Plaintiff-Appellee,

vs.

ERNEST E. POTTER,
Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF GEORGIA

Before RIVES, BELL and MORGAN, *Circuit Judges.*

BELL, *Circuit Judge:* This appeal is from a judgment rendered in favor of a corporation against an officer-director on a claim for profits due under § 16 (b) of the Securities Exchange Act of 1934,[1] 15 USCA, § 78p. We affirm

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[1] §§ 16(a) and (b):

(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a

(Footnote continued on following page)

as to liability. We vacate as to the amount of the judgment and remand with direction.

I.

Potter, an officer and director of Mouldings, Inc., placed 8,000 shares of Mouldings stock with Bache and Company, as his broker, for sale. Bache promptly sold the stock for $200,305.54 and, in turn, used the funds to purchase other securities for Potter at his direction.

The sales by Bache took place on November 6, 7, 18, and 19, 1969. On November 19, 1969, Bache discovered that the Potter stock was unregistered and restricted and thus could not be sold. This placed Potter in a short

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national securities exchange or by the effective date of a registration statement filed pursuant to section 12(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempt security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . .

position.[2] He was immediately obligated to replace the short shares. Either Potter or Bache could have purchased the necessary 8,000 shares on the open market. Meanwhile, the price of the stock had dropped sharply and Potter, as a seller and purchaser under § 16(b), would have been obligated to pay over the profits to Mouldings, Inc.

Potter asked for and received the cooperation of Bache in an arrangement by him whereunder he obtained shares from business associates, friends and a relative selected by him in order to meet his obligation to Bache.[3] This procedure at this point was no more than a sale and purchase just as if Potter or Bache had purchased on the open market. The profits would still have been due to Mouldings under § 16(b). Potter then went a step further in hope of avoiding payment to Mouldings and it is this step which is the nub of the controversy between the parties.

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[2] A short sale is defined by the rules and regulations of the Securities and Exchange Commission as:

> ". . . any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by or for the account of the seller." 17 CFR 240.3b-3.
>
> In such a sale the purchaser is altogether unaware whether he is buying from a short seller or from an actual owner of stock. The seller must deliver the stocks he has sold within the period limited by the rules of the Exchange. Since he has no shares to deliver, he must obtain them somewhere. The usual practice is for the broker executing the sale to borrow the stock on his customer's behalf. 2 Prentice-Hall, Securities Regulations, par. 11,213.

[3] This group consisted of Potter's father-in-law who made loans to Potter, a friend who had made a $55,000 unsecured loan to Potter, a person who thereafter went into business with Potter, Potter's banker who made loans to Potter at various times, an employee of Potter's, and a customer of Potter's.

II.

Potter conceived the idea of diverting the profits on the original transaction to the aforesaid group of business associates, friends and a relative (designees), rather than paying them to Mouldings, Inc. for the benefit of all its stockholders. He sought to give life to his conception by a process of novation. They would take his place in the transaction *ab initio*. He would return to Bache the sum which he had already received from Bache. The designees would take over his obligation to sell and Bache would pay them the original sum as sellers. This arrangement was made in December despite the fact that the Potter restricted stock had been sold and Potter was short; Potter had been paid; and the stock was selling for approximately one half the amount per share which Potter received in November. Potter's designees cooperated to the end of following instructions from Potter and Bache, paperwise and otherwise, in carrying out this conception and arrangement to the letter. Potter transmitted his check to Bache in repayment on February 2, 1970 and Bache paid the Potter designees on February 9, 1970. Thus the profits which Potter had made were made available to his designees.

Mouldings, Inc. brought suit against Potter for the profits inuring to him under the original sale and subsequent purchases. The cause of action was premised on § 16(b) and on attributing the purchases from the Potter designees to Potter rather than to Bache. The district court agreed and rendered summary judgment for Mouldings, Inc.

III.

On appeal, Potter asserts that the transaction was removed from the scope of § 16(b) by the novation

theory. As did the district court, we reject this contention. To do otherwise would exalt form over substance. It would immunize an officer and director of a corporation covered by the Act from the strictures of § 16(b) to the extent that he could deal as an insider and then favor selected stockholders with profits which would ordinarily flow to the corporation under § 16(b) for the benefit of all of its stockholders.

Potter urges that the district court erred in not applying the "possibility of abuse" test to the transaction in question so as to take the matter out of § 16(b). Our conclusion is that this test is inapplicable on the facts of this case. The transaction in question was no more than a mere sale and purchase. It fits precisely into the design of § 16(b): That design was to take any possible profit away from insiders fitting within the scope of § 16(b). Potter was such an insider.

The possibility of abuse test to be applied under § 16(b) was stated in *Blau v. Max Factor & Company*, 9 Cir., 1965, 342 F.2d 304, as follows:

> "The statutory definitions of 'purchase' and 'sale' are exceedingly general. They are given specificity by measuring questioned transactions against the purpose of section 16(b). Thus, a transaction is held to be a 'purchase' within section 16(b) 'if in any way it lends itself to the accomplishment of what the statute is designed to prevent.' *Blau v. Lehman*, 286 F.2d 786, 792 (2d Cir. 1960), aff'd 368 U.S. 403, 82 S.Ct. 451, 7 L.Ed.2d 403 (1962) . . . On the other hand, to avoid purposeless harshness, a transaction is held not to be a section 16(b) 'purchase' if it 'was not one that could have lent itself to the practices which Section 16(b) was enacted to prevent.' *Ferraiolo v. Newman*, 259 F.2d 342, 346 (6th Cir. 1958). . . . "

See also *Newmark v. RKO General, Inc.*, 2 Cir., 1970, 425 F.2d 348, 353; *Blau v. Lamb*, 2 Cir., 1966, 363 F.2d 507,

516; *Bershad v. McDonough*, 7 Cir., 1970, 428 F.2d 693, 696-7; *Petteys v. Butler*, 8 Cir., 1967, 367 F.2d 528.

Facts warranting a defense to a § 16(b) claim must rise above the case of a "garden-variety purchase and sale or sale and purchase within six months. . . ." *Abrams v. Occidental Petroleum Corporation*, 2 Cir., 1971, 450 F.2d 157, 162. The facts here did not raise above that level.

There are two statements of other courts which are appropriate to the plight of Potter in this case. In *Bershad v. McDonough*, supra, it was said:

> ". . . transactions subject to speculative abuse deserve careful scrutiny . . . The commercial substance of the transaction rather than its form must be considered, and courts should guard against sham transactions by which an insider disguises the effective transfer of stock."

In *Newmark v. RKO General, Inc.*, supra, it was said:

> "The threshold issue raised on this appeal is whether the purchase and subsequent exchange of Central shares lent itself to the type of speculative abuse which section 16(b) was designed to prevent. . . . That RKO's heart may have been pure and its motivation noble matters not. The significant factor is whether RKO *could have* reaped a speculative profit from the 'unfair use of information * * * obtained * * * by reason of [its] relationship to [Central].' Securities Exchange Act of 1934, § 16(b) 15 U.S.C. § 78p(b)."

The transaction here fits squarely into the remedial purpose of § 16(b) and there the matter ends if a profit was realized within the meaning of § 16(b) by Potter. We hold that there was.

IV

Section 16(b) requires the payment over of any "profit realized". This terminology is sufficiently broad to cover the transaction here in question. Potter realized the profits for the purpose of controlling them for delivery to his designees. The case of *Blau v. Lehman*, 2 Cir., 1960, 286 F.2d 786, 790-91, is not inapposite. There a partner in a brokerage firm was held liable for his share of profits to his firm from a purchase and sale of corporate stock of a corporation in which he was a director although he waived and disclaimed his share of the profits.

One intent of § 16(b) is to cast the officer-director thereunder into a fiduciary capacity for the benefit of all the shareholders in the corporation. We cannot countenance an effort by such a fiduciary to prefer some stockholders over others through control and designation of profits. On the fiduciary character of the officer-director under the Act, see *Smolowe v. Delendo Corporation*, 2 Cir., 1943, 136 F.2d 231, 239; *Adler v. Klawans*, 2 Cir., 1959, 267 F.2d 840, 844; *Western Auto Supply Company v. Gamble-Skogmo, Inc.*, 8 Cir., 1965, 348 F.2d 736, 740. We hold that the language of § 16(b): "any profit realized", embraces the transaction and designation here so as to hold Potter responsible.

V.

The district court assessed profits on the basis of the market value of the shares acquired from the designees as of February 9, 1970, the date on which Bache paid the designees are made the transfers on its book to reflect the substitution of the stock. Ordinarily the valuation under a § 16 (b) recovery is determined by market value. *Newmark v. RKO General, Inc.*, S.D. N.Y.,

1969, 305 F.Supp. 310, 315, aff'd, 425 F.2d 438, supra. Here market values are available and the price obtained by Potter is settled. The open question is the date on which the shares were acquired by Potter from the designees. This question of the date of acquisition was not explicated by the district court, doubtless because of the posture in which the case was decided, i.e., on motions for summary judgment by both parties on liability. It is true that Mouldings opted for the date of February 9 in its motion.

After decision for Mouldings, Potter asserted the question of the date being incorrect in a motion for reconsideration. This motion was denied.

The facts indicate that February 9 might or might not be the date of purchase to be applied to the transaction. There are other dates which might as a matter of fact be the date of purchase. We cannot determine the date in the first instance here and we are without findings of fact to support the date selected by the district court.

We vacate the judgment and remand for the limited purpose of the district court determining the correct date. This may be done from the facts already of record, or from the record as supplemented if supplementation seems indicated to the court in its discretion. We intimate no opinion as to which date may be the correct date. Such conclusion as the district court makes with respect to the date must be supported by findings of fact.

AFFIRMED in part; VACATED and REMANDED in part with direction.

JUDGMENT OF THE COURT OF APPEALS
(August 9, 1972)

No. 71-2867

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

MOULDINGS, INC.,
Plaintiff-Appellee,

vs.

ERNEST E. POTTER,
Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF GEORGIA

Before RIVES, BELL and MORGAN, *Circuit Judges.*

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Middle District of Georgia, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed in part and vacated in part; and that this cause be, and the same is hereby remanded to the said District Court with direction in accordance with the opinion of this Court;

It is further ordered that defendant-appellant pay to plaintiff-appellee the costs on appeal to be taxed by the Clerk of this Court.

ORDER OF THE COURT OF APPEALS DENYING PETITION FOR REHEARING AND PETITION FOR REHEARING EN BANC

(September 15, 1972)

No. 71-2867

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

MOULDINGS, INC.,
Plaintiff-Appellee,

VS.

ERNEST E. POTTER,
Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF GEORGIA

ON PETITION FOR REHEARING AND PETITION FOR REHEARING EN BANC

(Opinion Aug. 9, 1972, 5 Cir., 1972, ____ F.2d ____).

Before RIVES, BELL and MORGAN,
Circuit Judges.

PER CURIAM: The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (Rule 35 Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 12) the Petition for Rehearing En Banc is DENIED.

SECURITIES EXCHANGE ACT OF 1934

(15 U.S.C. §78)

Sec. 3(a)(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.

Sec. 3(a) (14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

* * * * *

Sec. 16(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

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[redacted]

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1972

No. 72-862

ERNEST E. POTTER,
Petitioner,

vs.

MOULDINGS, INC.,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Fifth Circuit

STATEMENT OF THE CASE

Respondent incorporates by reference and adopts the statements of fact contained in the opinions of the Fifth Circuit Court of Appeals (App., p. 32) and the District Court for the Middle District of Georgia (App., p. 19).

The petitioner's statement of the case contains several very basic errors which should be noted.

First, while it was not necessary for the lower courts to determine whether Potter knew, or did not know, that his Mouldings stock was restricted, there is substantial evi-

dence that Potter did, in fact, know that his shares were restricted. As the District Court Judge concluded:

> "Were it necessary for this Court sitting as a court of equity to decide (whether Potter was in fact aware that his shares were restricted at the time he delivered his certificates to Bache in November, 1969) we would have no difficulty in deciding that he did have such knowledge because such a conclusion is indicated by many circumstances" (App. p. 26).

Thus, Potter could hardly be classified as one who acted "unwittingly". The alleged 'predicament" Potter was in was of his own making.

Probably the most fundamental error which Potter makes in his statement of the case, as well as in his argument, is the assumption that he was in a position to assign the proceeds from his sale of Mouldings stock in November, 1969 ($200,385.54) to his friends (whose stock he purchased). The record is quite clear that Bache & Company ("Bache") acting as Potter's agent, and for his account, actually sold 8,000 shares of Mouldings stock on the American Stock Exchange in November, 1969 and the proceeds from these sales were promptly reinvested in other securities. Thus, there were no proceeds which could be assigned.

Potter is also wrong when he says that he arranged to "cancel his attempted sales and to transfer the sales to other persons whom he knew to be Mouldings stockholders and who would furnish unrestricted shares and receive in return the proceeds of the sales" (Petition, p. 5). The sales had already been executed on the American Stock Exchange and they were *completed*—not attempted—sales.[1]

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[1] The actual sales of Mouldings stock in November, 1969 occurred on the American Stock Exchange between Bache, as the selling broker, and other brokers who were purchasing Mouldings stock for their unidentified customers. The sales and pur-

Furthermore, the rules of the American Stock Exchange do not permit the cancellation of sales which have been executed on the Exchange, and, as a matter of fact, they were not cancelled.

Not only could the sales not be cancelled but also, as hereafter noted, Bache was unwilling to alter its records to coincide with Potter's cancellation theory; therefore the sales were neither cancelled in substance or in form.

The certified check which Potter refers to on page 5 of his petition was used by Bache to pay Potter's friends, and was not used to pay for the stock which had been purchased by Bache for Potter in November, 1969. This stock had already been paid for with the proceeds from the sale of the 8,000 shares of Mouldings stock. Potter is, in effect, contending that Bache financed the purchase by him of securities costing in excess of $200,000.00. This would have constituted a serious violation of the law and Bache would not, and did not, do this.

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chases were in no way dependent upon when, or whether, the respective brokers customers fulfilled their obligations to them. On the contrary, once a broker such as Bache executes a sale on the floor of the American Stock Exchange, the **sale** is complete and the selling broker immediately becomes obligated to deliver to the brokers who made the purchases the number of shares sold; and if the selling broker fails to deliver then the broker who made the purchases can buy the necessary shares on the Exchange and charge the cost thereof to the selling broker. The selling broker, of course, looks to its customer for delivery, and if the customer fails to deliver to it, then it can also buy the shares on the Exchange and charge its customer's account (the customer having received the proceeds from the sales). See Israels and Guttman, Modern Securities Transfers (1967), p. 603.

REASONS FOR DENYING THE WRIT

I. The Decision of the Fifth Circuit Court of Appeals Was Correct.

A. Potter's contention that the transactions were recast in a form which enabled him to avoid the provisions of section 16(b) is without merit.

Before commenting on the several theories advanced by Potter in support of his "form" argument, it should first be noted that a very basic problem with this contention is that actually nothing was done to change the form of the transactions, the "form" being the sale of 8,000 shares of Mouldings stock in November, 1969 by Bache for Potter's account, and the covering purchases of 8,000 shares by Bache for Potter's account in February, 1970. The sole basis of Potter's argument is a set of self-serving letters which Potter had his friends sign. While the letters requested Bache to "transfer the sales" which Potter had made in November to accounts which would be opened in the friends' names, Bache did not change its records to coincide with Potter's theory. Instead, Bache's records reflect the fact that the November sales were made by Potter and the 8,000 shares of Mouldings stock credited to Potter's account in February, 1970 were acquired from Potter's friends with funds supplied by Potter. Thus, there is no substance to Potter's "form" argument.

As for the specifics of Potter's contention, the Court of Appeals not only took issue with his novation argument, it summarily rejected it. This argument was based on the false assumption that Potter was in a position to assign the proceeds from the November, 1969 sales of Mouldings stock to his friends. As already discussed, this could not be done since the proceeds had not only been received, but

they had also been reinvested in other securities. There were no proceeds to assign.

Another obvious problem with the novation argument is that the sales had already been executed—they were not "attempted" sales. Bache, as Potter's agent, completed the sales in accordance with the rules of the American Stock Exchange, and Potter's duty was to Bache, as his agent, and not to the persons who actually purchased the stock on the Exchange.

There was no reason for the Court of Appeals to consider the "rescission" cases because the November sales were not rescinded. As already noted, the rules of the American Stock Exchange do not permit sales to be rescinded. Furthermore, even if the rules did authorize rescission, no rescission could have been accomplished without the participation of the persons who bought the stock. In this regard, Potter overlooks the fact that Bache did not buy his stock in November. Bache acted as Potter's agent and there was nothing that Potter, as the seller, and Bache, as his agent, could do between themselves which would have the effect of rescinding the sales. This is elementary.

The Court of Appeals "ignored" **Emerson Electric Company v. Reliance Electric Company**, 306 F. Supp. 588 (E.D. Mo. 1969), rev'd, 434 F2d 918 (8th Cir. 1970), aff'd, 92 S.Ct. 596, for the simple reason that **Reliance** involved a set of facts, and holding, not in the least bit analogous to the case under consideration.

B. **The Court of Appeals correctly concluded that the possibility of abuse test was inapplicable.**

Potter's possibility of abuse argument is based upon his contention that there was a novation which, as discussed above, there was not.

The possibility of abuse test has been applied only in those cases which involved transactions which are unorthodox, such as conversions, options, reclassifications and the like. Here, we are concerned only with sales and purchases and that being true Section 16(b) applies automatically, regardless of the insider's motives or intentions.

Although the possibility of abuse test is inapplicable, it should be noted that this was a situation where Potter could have benefited from his position as an insider.

While it was not necessary for Mouldings to show that Potter actually took advantage of inside information when he decided to sell Mouldings stock in November, 1969, the evidence strongly indicates that in all probability he did. Potter wanted to dispose of all of his Mouldings stock (except those shares evidenced by legended certificates) and almost immediately after the November sales the price of Mouldings stock dropped significantly. As an officer and director, Potter was certainly in a position to foresee what lay ahead for Mouldings stock. It also should be noted that Potter promptly reinvested the proceeds in other securities and so obviously he was worried about the future of Mouldings stock in particular, and not the stock market in general.

It is no doubt true that Potter originally did not intend to purchase any more Mouldings stock since he obviously hoped that it would not be discovered that the certificates which he had delivered to Bache represented restricted shares. However, when Potter sold Mouldings stock at a time when he did not own any unrestricted shares which could be delivered to his broker, he was assuming the risk that he would have to subsequently purchase unrestricted shares to fulfill his obligations to his broker.

As discussed in the opinion of the Fifth Circuit Court of Appeals, when Bache sold Mouldings stock for Potter's

account at a time when he did not own any unrestricted shares, Potter, in effect, was selling "short", and by selling short, he violated Section 16(c) of the Securities Exchange Act of 1934, which provides:

> "It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer . . ., if the person selling the security or his principal (1) does not own the security sold . . ." 15 U.S.C.A., Section 79p(c).

In **Silverman v. Landa**, 200 F. Supp. 193, the Court stated:

> "The legislative history of Section 16(c) makes clear that Congress was concerned with 'short sales' and 'sales against the box' as that type of trading was used by corporate insiders deriving large profits from transactions in their company's securities while they were concealing the fact that they were so engaged."

In view of the specific provisions of Section 16(c), Potter is hardly in a position to argue that this was not the type of transaction which lends itself to the preferential use of inside information. While it is true that Potter could perhaps have avoided Section 16(b) by waiting at least six months before purchasing the shares from his friends, he did not wait, and thus not only did he violate Section 16(c), but he also brought himself squarely within the provisions of Section 16(b).

It also should be pointed out that if the lower courts had accepted Potter's argument that Section 16(b) should not apply in situations such as this, an insider with unlegended stock would be encouraged to follow the same course as Potter did with the knowledge that if he got caught he could still salvage something from the transaction by paying his profits to his friends, rather than to

the corporation. The insider would have nothing to lose, and possibly a great deal to gain.

The fact of the matter is that Potter **knew** that Section 16(b) applied and that is why he paid the profits to his friends. He realized that if he had not, there would be no way at all to even attempt to prevent the profits from going to Mouldings. Apparently what he did not realize was that it is Section 16(b) and not the insider who determines where such profits shall go.

C. **The court of appeals correctly concluded that Potter realized profits.**

Since Potter clearly made sales and purchases of Mouldings stock within a six months period the final consideration was whether he **realized** profits from these transactions. As both lower courts observed, Potter controlled the disposition of a substantial sum of money and in so doing he realized profits within the meaning of Section 16(b).

On February 2, 1970, the date Bache received the certified check for $200,385.54 from Potter, it had two alternatives. The first alternative, and the one that would have been followed had it not been for Potter's express instructions to the contrary, was for Bache to have bought the stock on the American or Pacific Stock Exchanges. Had it made these purchases on February 2, it could have acquired 8,000 shares for $95,000.00 since Mouldings closed at $11.87½ on that date, and had it made the purchases on February 9, the date the purchases from Potter's friends were consummated, it could have acquired the same number of shares for $97,000.00.

If Bache had paid the market value of the Mouldings stock, which it would have done had it not been for Pot-

ter's directions, then, without question, Potter would have had to have immediately sent Mouldings a check in an amount equal to the difference between what Potter received for the 8,000 shares which he sold in November and what he paid for a like number of shares in February. There would simply have been no way for Potter to have even attempted to disguise the fact that a substantial profit was realized. Potter was well aware of this, and that is why he instructed Bache to follow the second "alternative."

The second "alternative" (and it was an alternative only because Potter made it so) was to buy the shares from Potter's friends and to pay them the same amount per share that Potter had received in November. However, the fact that Potter's friends were thus able to sell their Mouldings stock for approximately $25.00 per share **in no way changed the fact that on February 9, 1970 the actual market value of their stock was only $12.12½ per share.**[2]

It is quite obvious that what Potter was doing was giving to his friends the money ($103,385.54) he would otherwise have had to pay to Mouldings had the shares been purchased on either Exchange. Potter was thus trying to circumvent Section 16(b) by paying the profits which belonged to Mouldings and all of its stockholders to a select group of Mouldings stockholders comprised exclusively of his friends. The lower courts were correct in holding that not only did Potter not have the right to keep the profits for himself, but also he did not have the right to direct and control where they went. Partial compliance with Section 16(b) will not suffice.

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[2] The computation of profit for purposes of Section 16(b) depends on valuation which is generally determined by market value on the date of the transaction. **Newmark v. RKO General, Inc.**, 305 F. Supp. 315 (S.D.N.Y. 1969), Aff'd 425 F. 2d 348 (2d Cir. 1970), Cert. den. 400 U.S. 854.

Because of Potter, and only because of him, this select group of Mouldings stockholders was thus able to sell its Mouldings stock for more than twice its market value. Had Potter's friends been so inclined they could have immediately purchased the same number of shares of Mouldings stock which they sold to Potter and they would have retained their identical equity positions **plus** a profit of $103,385.54. This, of course, is the same profit which Mouldings should have received, and would have received had Potter not decided to pay it to his friends rather than to Mouldings.

Potter can find no comfort in the fact that he gave the profits to his friends, rather than keeping them for himself, because he realized the profits by controlling and directing where they went. Insofar as the other stockholders of Mouldings are concerned the profits which Potter gave to his friends might just as well have been retained by him. The effect on them was the same.

Section 16(b) is designed to do more than "punish" the insider who has taken advantage of inside information. As the District Court for the Southern District of New York stated in **Epstein v. Shindler**, 200 F. Supp. 836 (1961):

> "There is, unquestionably, a public interest sought to be protected by the Securities Exchange Act. But it is not the public at large which is specifically protected by Section 16(b) so much as the 'outsiders', that is, the general body of stockholders not having the advantage of inside information. The statute redresses a wrong to them by the return of profits to the corporation itself."

The wrong suffered by the stockholders of Mouldings was not diminished in the slightest by the fact that Potter gave the profits to his friends rather than keeping them for himself.

Potter is also wrong when he says that Potter never brought any profits into his possession. Potter had already received the proceeds from the November sales, and, in February, the only question was to whom he had to pay the profits. Obviously, Potter had complete control over the profits, as evidenced by the payments to his friends.[3]

The principles set forth in **Blau v. Lehman**, 173 F. Supp. 590 (S.D.N.Y. 1959) aff'd, 286 F. 2d 786 (2d Cir. 1960), aff'd, 368 U.S. 403 (1962), are applicable. In **Blau**, the District Court stated:

> "If his waiver was effective to transfer his share of the profits to his partners, then it is clear that by making such transfer of profits he was disposing of profits and to that extent he 'realized' the profits." Id. at 595.

In a footnote, the Court observed:

> "For taxation purposes income has been held to be 'realized' when it is made subject to the will and control of the taxpayer, and could be, except for his own action or inaction, reduced to actual possession. (Citation.) See also **Helvering v. Horst**, 1940, 311 U.S. 112, wherein realization of income was defined as the power to procure payment to another." Id. at 595, f.n. 2.

One additional point which should certainly be made is that if an insider were at liberty to buy stock at whatever price he saw fit, a vehicle for gross abuse of Section 16(b) would be available. To illustrate, an insider might perceive that the company's stock was going to decline, and for

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[3] Where stock is first purchased and then sold, the insider receives the profits when the sales are executed; however, when the sales precede the purchases the profit must be measured by the difference between the amount received when the stock was sold, and the cost of the stock when the purchases are made. The insider, of course, does not receive the profits in the form of cash at the time the purchases are made.

that reason it would be advisable to sell, yet at the same time he might want to retain his equity position. Under Potter's theory, the insider could sell his stock, and then buy stock back from friends and family and pay the profits which would have gone to the company to his friends. (His actions would have created a profit based upon the difference between the proceeds received and the market value of the stock subsequently purchased). In such a situation, the insider would obviously derive substantial indirect benefits, and in many instances he might receive direct benefits in the form of money, services, favors, etc.

It would jeopardize the effectiveness of Section 16(b) to require the corporation to prove the value of the indirect benefits (which could be substantial), or to prove that the insider was to receive tangible benefits at some point in the future. It would be quite possible for an insider to have an "understanding" with his friends and/or family which could be framed in such a manner as to be easily disguised, or covered up. Likewise, it is difficult indeed to place a dollars and cents value on the substantial intangible benefits which obviously inured to Potter's benefit.

But even if it could be conclusively shown that the insider would receive absolutely no benefits of any kind, the fact would still remain that the insider had controlled and directed the disposition of a substantial sum of money in contravention of Section 16(b), and the other stockholders would have been damaged just as much as they would have been had the insider retained the profits.

II. There Are No "Special and Important Reasons" for Granting the Writ

Even if Potter were correct insofar as his attack on the opinion of the Fifth Circuit Court of Appeals is concerned (and he hasn't), he has completely failed to demonstrate

that there are any "special and important reasons" for writ of certiorari to be granted.

Once the facts are understood it is obvious that Section 16(b) was applied properly, and there is no reason for this case to be reviewed by the United States Supreme Court.

Also, it should be noted that as a practical matter it is highly unlikely that this factual situation will be repeated again for at least two reasons. First, it can be reasonably assumed that relatively few transfer agents make the mistake which was made here, to-wit, the failure to place legends on certificates evidencing the ownership of restricted stock; and, second, if and when a mistake such as this is made in the future, it can also be reasonably assumed that the person, or persons, affected, will not attempt to take advantage of the mistake in the manner Potter did.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for writ of certiorari should be denied.

Respectfully submitted

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